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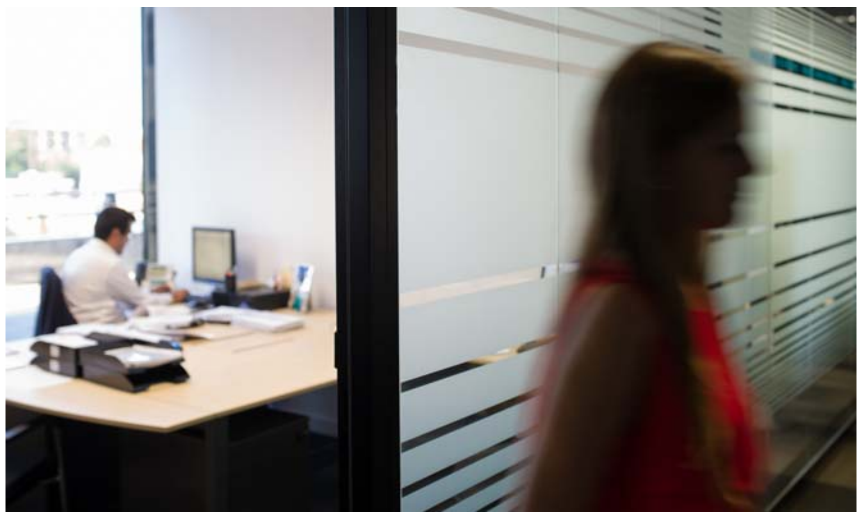
TAX BRIEFING

SPANISH TAX REFORM: MAIN ISSUES FOR M&A AND FINANCING TRANSACTIONS

DECEMBER 2014

THIS BRIEFING FOCUSES ON THOSE MEASURES INCLUDED IN THE CIT ACT WHICH AFFECT M&A, FINANCING & REFINANCING TRANSACTIONS.

THE CIT ACT WILL ENTER INTO FORCE FOR FISCAL YEARS COMMENCING AS OF 2015.



The Spanish parliament has recently approved the following bills which introduce significant changes to the spanish tax system:

- Law 26/2014, of 27 November amends Law 35/2006, of 28 November, on Personal Income Tax and the Law on Non-Residents Income Tax, as approved by Royal Decree-Law 5/2004, of 5 March, along with other tax rules;
- Law 27/2014, of 27 November on Corporate Income Tax ("CIT"); and
- Law 28/2014, of 27 November amends Law 37/1992 of 28 December on Value Added Tax; Law 20/1991 of 7 June, amending tax aspects of the Economic and Tax Regime of the Canary Islands; Law 38/1992, of 28 December, on Excise Taxes, and Law 16/2013, of 29 October which sets out certain measures in environmental taxation and other tax and financial rules.

This Briefing focuses on those measures included in the CIT Act, which affect M&A transactions, and financing and refinancing transactions. The CIT Act will enter into force for fiscal years commencing in 2015.

CIT rate
The general CIT rate is reduced from the current 30% to 28% in 2015 and to 25% from 2016.

NOLs
There is no time limit in which tax losses can be carried forward, however the utilisation of carried forward tax losses is subject to certain restrictions:

For fiscal year 2015, the existing limitations provided for large companies of between 25% and 50% of the taxable income for that period are still applicable.

During 2016 tax losses carried forward may utilise up to 60% of taxable income or up to €1 million – as per an amendment recently included in the Draft Budget Bill for 2015.

From 2017 onwards tax losses carried forward may utilise up to 70% of taxable income or up to €1 million, whichever is the greater.

Interest
Interest deduction continues to be limited to 30% of the operating profit (similar to EBITDA), or up to €1 million each year, whichever is the greater.

There is no time limit for interest to be carried forward.

Profit Participating Loans (“PPLs”)
Interest on PPLs granted between companies belonging to the same group are no longer deductible, as long as PPLs are deemed to be equity. This restriction is unlikely to apply to the fixed interest component of PPLs, but rather the variable component.

Income in the case of a non-Spanish lender will likely be taxed as a dividend for withholding tax purposes.

A grandfather provision has been put in place whereby such restrictions do not apply to PPLs granted before 20 June 2014. In such cases interest will continue to be tax deductible.

Other instruments, such as voting shares or redeemable shares, which are deemed to be equity for legal purposes but as a financial liability for accounting purposes, are also non-deductible.

Hybrid transactions
Expenses derived from transactions with parties which, as a consequence of a difference in tax qualification, do not give rise to taxable income or income which is taxable at a nominal tax rate lower than 10%, are non-deductible.

Acquisition debt
The deduction of interest derived from acquisition debt is limited to 30% of the operating profits of the acquiring company in cases where, within four years following acquisition, the acquired company is merged or joins the tax group of the acquirer.

As such, when the acquirer is a mere holding company, acquisition debt would not be deductible since the operating profits of the acquired company cannot be considered for calculating the operating profits of the acquirer.

The above does not apply during the tax year in which the acquisition takes place, provided that acquisition debt does not exceed 70% of the acquisition price.

Moreover, it will also not apply if the acquisition debt is reduced by 5% or more during each of the following eight years until it reaches the 30% of the acquisition price.

Finally, the law provides a grandfather provision whereby the above-mentioned 30% restriction will not apply to mergers or inclusions within a tax group carried out before 20 June 2014.

Asset impairment

Impairment of fixed material, real estate and intangible assets, including goodwill, becomes non-deductible.

Participation exemption for dividends and capital gains

The participation exemption regime for dividends and capital gains from foreign companies is extended to include those from Spanish companies. In order to qualify for the exemption the following requirements must be met:

- direct or indirect shareholding of at least 5%, or an acquisition value higher than €20 million;
- a holding period of one uninterrupted year;
- a foreign subsidiary must be subject to an identical or analogous CIT tax applied at a minimum nominal rate of 10%. This condition is fulfilled when a tax treaty with information exchange clause applies.

Shareholdings on passive companies do not qualify for the capital gains exemption.

Tax consolidation

Some changes have been made to the definition of a “tax group”. Spanish companies held by a non-Spanish resident parent entity may apply to be considered a tax group, provided that the non-resident parent company i) is not located in a tax haven jurisdiction; ii) has its own legal personality; and iii) is subject to and not exempt from a tax identical or analogous to the Spanish CIT.

Spanish subsidiaries indirectly held through companies that do not form part of the tax group, (i.e. through Spanish non-resident companies) must join the tax group.

It is now required that the parent company holds the majority of the voting rights in the affiliate company, in addition to the minimum 75% shareholding, throughout the whole tax period.

Parent-Subsidiary dividends exemption

The Non-Resident Income Tax Act provides that it is possible to qualify as a parent company having a direct or indirect shareholding percentage lower than 5%, when the acquisition value is greater than €20 million.

The dividends exemption is extended to parent companies located in countries belonging to the European Economic Area (including Iceland, Liechtenstein and Norway) with which there is an information exchange agreement on taxation, and which comply with the rest of Parent-Subsidiary Directive requirements.

It is envisaged that, provided there is reciprocity, this exemption will be extended to subsidiaries that have a different legal form to those provided for in the Parent-Subsidiary Directive, as well as to dividends distributed to parent companies having a direct or indirect shareholding percentage of at least 5%, or a shareholding acquisition value higher than €20 million, as long as the rest of the requirements are met.

The anti-abuse rule has also been modified. Now, the dividend exemption does not apply when the majority of the voting rights in the parent company are held, directly or indirectly, by entities or individuals not resident in the European Union or in a country belonging to the European Economic Area with which there is an information exchange agreement on taxation. However, in such cases the dividend exemptions can still apply if the incorporation of the EU parent company is due to valid and substantive business reasons.

Comment

The measures discussed in this Briefing are considered in relation to new M&A and financing transactions, and may be applied to some existing transactions that may need to be revisited.

CONTACTS

Should you like to discuss any of the matters raised in this Briefing, please speak with a member of our team below or your regular contact at Watson Farley & Williams.

LUIS SOTO
Partner
Madrid

+34 91 515 6305
lsoto@wfw.com

MARÍA PILAR GARCÍA GUIJARRO
Partner
Madrid

+34 91 515 6301
mpgarcia@wfw.com